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Peter Hurdell  
Finance and Expenditure Committee Secretariat  
Parliament Buildings  
WELLINGTON

Dear Sir

**Submission on Deferred Deduction Rule  
Clause 14 of the Taxation (Annual Rates, GST, Trans-Tasman  
Imputation and Miscellaneous Provisions) Bill (“the Bill”)**

**Introduction**

Clause 14 of the Bill introduces the deferred deduction rule that will be contained in subpart ES of the Income Tax Act 1994 (“the Act”). The rule is targeted partly at film and television financing arrangements and it will, therefore, adversely affect the New Zealand film and television industry.

We are strongly opposed to any legislation that impacts adversely on the development of the film and television industry. We are particularly concerned at the potential effect on smaller producers in New Zealand.

## Points of Principle

### *Timing*

In the context of the Screen Industry Task Force report and Government commitment to support and develop our industry, we find it perplexing that legislation which will reduce the ability of the film and television industry to attract funding and to prosper should be being considered at this time. There is considerable work that needs to be done in evaluating and coordinating forms of Government assistance to encourage industry growth and the wider economic implications of such assistance, including considering a case for supportive tax policy.

### *Funding for the film and television industry*

Raising funds for film and television shows is extremely difficult. Producers usually have to obtain funds from a variety of sources including the New Zealand Film Commission, The Film Fund Production Trust, New Zealand on Air, broadcasters, distributors, studios and private investors.

This task has never been easy but it has become extremely difficult in recent times. The Film Fund Production Trust is now fully committed. Overseas pre-sales have virtually disappeared in the major territories. Production costs have increased substantially due to the increased scale of films made for international release, the increase in the exchange rate and other factors. The international climate for investment has also declined as a result of the decline in the global economy.

Investment in the film and television industry is very high risk. It costs a lot to produce a film and the funds involved generally have to be spent before revenue is derived. Until a film is released there is very little certainty that it will be successful. Previous Governments have recognised this by allowing a 100% write off for the cost of producing a film or television show over one or two years following its completion.

The deferred deduction rule will effectively reverse the 100% write off currently available to investors. The rule will limit the tax savings available to investors to a maximum of 78% of the amounts invested.

Given the high risk nature of the industry, it is unlikely that producers will be able raise funds from the private sector if the deferred deduction rule is enacted. The rule will therefore significantly impact on the development of the film and television industry.

In our view, the deferred deduction rule should not apply to the film and television industry. The existing film tax provisions have a strong anti-avoidance focus and, with the legislative changes of recent years, they are now sufficiently robust to counter "aggressive tax arrangements". Most importantly, they provide a reasonable balance between the need to promote investment in the film and television industry and the need to maintain the tax base.

### *Incentives for the domestic film and television industry*

The Government has recently announced the introduction of an incentive for film and television productions involving New Zealand production expenditure of at least \$15 million.

We strongly support the introduction of this incentive and see it as a very positive move for the film and television industry. However, it will mainly benefit large overseas productions and very few domestic productions will qualify for the incentive.

We understand the Government are currently considering various measures to support the domestic film and television industry. In the absence of additional funding support for the domestic industry, we believe it is premature to introduce the deferred deduction rule in relation to our industry.

### *Application to genuine commercial arrangements*

The deferred deduction rule is “designed to combat aggressive tax arrangements, many of which are mass marketed”. Unfortunately, no attempt appears to have been made to distinguish genuine commercial arrangements from those that have been contrived to produce a tax advantage. There are already provisions in the tax legislation which enable the Inland Revenue Department to combat aggressive tax arrangements.

As “film production expenditure” is currently 100% tax deductible over one or two years and all film and television shows are made with “money that is not at risk”, virtually all domestic film and television shows will be subject to the deferred deduction rule.

We do not believe it is appropriate to introduce legislation that will penalise genuine commercial activity in the film and television industry.

### *Reverse engineering*

There is an obvious element of "reverse engineering" in relation to these measures. They appear to have been based upon the features of transactions that the Inland Revenue Department has found objectionable.

We understand that the Department is already addressing these "objectionable" transactions, which raises the question why this legislation is required at all. A significant difficulty with this kind of "reverse engineering" approach is that it tends to be prescriptive.

It is easy, on one hand, to catch transactions at which the legislation is not directed and, on the other hand, for a sufficiently motivated person to seek to structure around the new measure. Further, if at least one of the "objectionable" transactions has been attacked and settled under the current law, why change the law?

### *Valuation*

In the Commentary on the Bill, it is stated that “The valuation of assets used in the arrangements in question is the most problematic feature of these arrangements, so it should ideally have been the target of any legislative response. Targeting valuation, however, would be very difficult because the forecasts of income that underpin valuation of assets involved are inherently difficult to determine and are very subjective. Instead the rule focuses on situations where investors do not have to pay for the assets they acquire as a proxy for dealing with valuation directly.”

While valuation may be an issue in relation to expenditure incurred in acquiring rights in a film or television show, it is not relevant to expenditure incurred in producing a film.

The cost of producing a film or television show is easy to verify (being the sum of the amounts paid to the actors, crew and other suppliers involved in the show) and robust anti-avoidance provisions already exist to counter arrangements designed to inflate the cost of producing a film (for example, section GC 11).

As targeting valuation is not an issue for the cost of producing a film or television show and robust anti-avoidance provisions already apply, the deferred deduction rule should not apply to “film production expenditure”.

### **Detailed submissions on deferred deduction rule**

If our above submissions are not accepted and the deferred deduction rule is to apply to the film and television industry, then a number of changes should be made to the legislation to lessen the impact of that rule on the industry and to ensure it only applies to “aggressive tax arrangements”.

We believe that changes should be made to the legislation in the following areas:

#### *Definition of Promoter*

The criteria that, if met, trigger the deferred deduction rule are contained in Section ES 1. The first of these requirements is that the arrangement must have a “promoter”.

The term “promoter” is very widely defined and it would appear to apply to most producers, production companies and studios that raise finance for the film and television industry. In fact, we cannot think of any film or television show involving private investment that would not have a “promoter”.

It would, therefore, seem to us that the requirement in section ES 1(1)(a) that “the arrangement has a promoter” is redundant. Presumably, this is not what was intended by the drafters of the legislation.

We believe the definition of “promoter” should be amended to make it clear that the deferred deduction rule will only apply where the opportunity to invest in a film or television show is promoted to one or more passive investors. In this context, the term passive investor would mean someone who is not actively involved in the production of the film or television show.

#### *Exclusion for arms-length loans from banks operating in New Zealand*

Section ES 2(3)(b) excludes from the definition of “money that is not at risk” loans that are made on arm’s-length terms by New Zealand financiers and overseas banks carrying on business in New Zealand through a fixed establishment in New Zealand.

We think this exclusion is too narrowly drafted. The film and television industry is a global industry and film financing is often sourced from specialist overseas banks that don’t carry on business in New Zealand through a fixed establishment in New Zealand. We think the exclusion should also apply to these banks.

If appropriate, provision could be made for overseas banks to qualify for the exclusion if they meet certain specified requirements. For example, the exclusion could apply to banks that are listed on a recognised overseas stock exchange, are subsidiaries of companies that are listed on a recognised overseas stock exchange and/or are resident in countries with which New Zealand has a double tax agreement. Adopting this approach should overcome any concerns there may be regarding access to information, and the genuineness of the banks.

We note that the Inland Revenue Department already has substantial powers to obtain information from overseas (for example, section 21 of the Tax Administration Act 1994). If necessary, specific provision could be made for these loans to be excluded from the definition of “money that is not at risk” only if the information requested by the Department is provided within a reasonable timeframe.

#### *Money not at risk 50% or more of total cost of property*

Section ES 1(1)(e) contains the requirement that “the total of the money that is not at risk for the person and any affected associated persons is 50% or more of the total cost of the property held by those persons...”, which must be satisfied before the deferred deduction rule applies.

We think the ratio of 50% is too low and a ratio of 75% is more appropriate. We acknowledge that this figure could result in film investors initially receiving more tax savings than the money they invest in the show. However, a 75% ratio represents a much better balance between:

- (a) Recognising that the screen production industry has a key role to play in the future success of this country and that it is essential the industry be able to raise funds from the private sector;

- (b) Recognising that the existing film tax rules are intended to be concessionary and stimulate growth within the industry;
- (c) Minimising the risks of the deferred deduction rule applying to genuine commercial arrangements that should not be caught by that rule;
- (d) Protecting the revenue base.

In our view, the ability of investors to receive more tax savings than the money they have invested needs to be better balanced against these other objectives.

If necessary, provision could be made for a one-off adjustment to be made in, say, year seven to recoup any excess tax savings obtained by investors over and above the amount of money they invested in the show.

If a 75% ratio is not acceptable, then as an absolute minimum we believe a 61% ratio should be adopted. With a 61% ratio, investors on the top marginal tax rate of 39% will receive tax savings that will always be less than the amount invested. It has to be recognised however that corporate investors will receive tax savings of less than the amount invested at this level, and 67% would be an appropriate percentage for such investors.

In practice, film investors will almost always have “money that is not at risk” that is less than the maximum ratio because of the need to provide for contingencies in production budgets and because cost overruns could result in them having “money that is not at risk” that exceeds the specified ratio, which would result in their tax savings being limited to a maximum of 39% of the amount invested.

### *Section DK 1*

Section DK 1 provides for tax deductions for film production, acquisition and marketing expenditure to be reduced when that expenditure is funded from a limited recourse loan.

An arrangement that is subject to section DK 1 is subject to a similar deferral (possibly permanent) to that applying under the deferred deduction rule. A similar result is also obtained under section DC 3 and possibly under the terms of certain loans made by The New Zealand Film Commission, The Film Fund Production Trust, New Zealand on Air and possibly certain other Government agencies.

Section DK 1 is to be repealed. We disagree with this approach. As section DK 1 achieves essentially the same result as the deferred deduction rule without adversely impacting on the 50% ratio discussed above, this section should be retained. Loans subject to sections DC 3 and DK 1 and any loans from The New Zealand Film Commission, The Film Fund Production Trust, New Zealand on Air and other Government agencies should be specifically excluded from the definition of “money that is not at risk” and the cost of the relevant property.

### *Retrospectivity*

The deferred deduction rule will apply to “existing arrangements when 70 percent of the deductions claimed arise in respect of fixed life intangible property or software, or it can reasonably be expected that there are ten or more investors”.

It would appear that the rule could apply to existing film and television productions that have ten or more investors. We do not accept that the deferred deduction rule should apply retrospectively to the film and television industry.

The film and television industry has been subject to its own tax legislation for over twenty years. The existing rules have a strong anti-avoidance focus and they have been strengthened from time to time (most recently in 1999) to counter arrangements considered unacceptable.

Given that film investors are already subject to robust anti-avoidance focused legislation, we believe it would be extremely unjust to retrospectively impose the deferred deduction rule on these investors.

We believe that clause 14(2) of the Bill should be amended to exclude existing investors in film and television shows.

### **Conclusion**

We believe the deferred deduction rule should not apply to the film and television industry.

If this approach is not acceptable, then a number of changes should be made to the legislation to lessen the impact of the deferred deduction rule on our industry and to ensure the rule only applies to the “aggressive tax arrangements” that it is intended to apply to.

We would like the opportunity to appear before the committee to speak to our submission. We can be contacted on (04) 939 6934.

Please contact us if you have any queries regarding this submission.

Yours faithfully,

David Baldock, Nicole Hoey, Bettina Hollings, Rachel Jean, Angela Littlejohn,  
Veronica McCarthy, Philippa Mossman, Robin Scholes, Robyn Scott-Vincent,  
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